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REAL ESTATE

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OUTLOOK

January 1989

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The U.S. Department of Commerce made relatively few changes in December to its estimate for third quarter real GNP growth; the final estimate is now at 2.5 percent, virtually unchanged from the prior estimate of 2.6 percent. However, while the pace of economic growth may be slowing down, the economy still maintains a hearty head of steam heading into 1989.
- The November employment report showed a surprisingly large advance in employment of 465 thousand new jobs. This employment report adds to the list of indicators that the economy may be growing too quickly, and that inflationary pressures could be mounting.
- The Federal Reserve tightened credit in December in response to higher foreign interest rates, a softer dollar, and continued strong U.S. economic growth.
- Starts of privately owned homes reached a seven month high in November at a seasonally adjusted annual rate of 1.563 million units, up 1.4 percent from the October revised pace of 1.542 million units.
- Following a revised 1.4 percent drop in September (previously estimated at negative 7.8), new single-family home sales rose by 3.5 percent in October to a seasonally adjusted annual rate of 733 thousand units, marking the fastest pace since February 1987.
- Sales of existing single-family homes rose to a seasonally adjusted annual rate of 3.71 million units in November, 1.1 percent above the October 1988 annual rate of 3.67 million units.
- The median sales price of an existing single family home fell slightly in November to $87,900, 0.2 percent below the October median sales price of $88,100, and 3.4 percent above the November 1987 median price of $85,000.

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A Revolutionary Prospect

Economic Commentary

by
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When Cornwallis' defeated army marched from the field at Yorktown, the British band played "The World Turned Upside Down". In fact it had -- the most prosperous, progressive, assimilated of all the colonies in the British Empire had severed itself forever from mother England. If we could bring back Cornwallis' band for an encore after two centuries, it would be appropriate to ask them to play on Wall Street, for in financial markets we have seen the world turn upside down.

Consider corporate securities. Once considered the bedrock of the market, these are now in considerable disrepute. First the crash soured the love affair between the American public and corporate equities. The market will go up and down, and in fact will probably soar during the nineties. But for now, October 19, 1987 changed the way investors look at stocks. The debt side is hardly more encouraging. Leveraged buyouts, with their associated massive bond issues, have made the staid old corporate bond market suspect. Where once quality was assumed, now nothing is certain. In fact, the current debt sweethearts are brazen hussies like junk bonds and dowdy spinsters like Federal government paper.

But the real inversion has taken place among financial intermediaries. During this decade, we have seen shattered all the comfortable truths we associated with the word "bank." The farm crisis, the collapse of oil prices and the inability of the developing world to develop have sapped the capital strength of large commercial banks and forced the closing of scores of others. The result has been a disenchantment with and exodus from the banks to their investment fund substitutes, just as the major broadcast networks have lost viewers to the cable systems.

The problems of the banks, though, pale in comparison to the immediacy and looming cost of the savings and loan industry. It's ironic that those institutions set up "to encourage thrift and promote homeownership" are bankrupt and unable to put their own house in order. Now, the papers are so full of fingers pointing out who's to blame for this that one would think the industry has absorbed the entire Dukakis campaign staff. But the issue is complex, and as we slouch toward a public expenditure of considerable size to bail out the industry, it is worthwhile to look at the variety of causes that brought us here.

In reality, the thrift crisis is not the result of a single cabal, but rather the complex interaction of at least four factors. *Deregulation* permitted the thrifts to wander off the reservation and engage in lines of business for which they were ill-equipped. In a more subtle vein, the detailed regulatory structure that limited financial institutions prior to 1980 created excessive numbers of banking firms. Per capita, the U.S. has over 100 times the number of depositories as Canada (and that excludes credit unions). When the regulatory straitjacket was removed, the industry had to consolidate.

Fraud and mismanagement were clearly present in the industry. In the eighties a number of sharp operators, who saw how to use the relatively lax regulatory and examination systems to their personal gain, got into the industry. Their entry was eased by the vacuum resulting from weak management throughout the industry. Put simply, when the world turned upside down, many thrift managers found themselves ill-equipped to deal in modern financial markets, and their institutions suffered.

Finally, *regional depression* added a final nail to the coffin. In the Southwest, where construction plans went forward on the assumption that oil prices in dollars would match the last two digits of the year, many loans that looked good at closing soured very quickly. When the oil and farm economies collapsed, a significant number of institutions were doomed. Of course, all four of these factors have an interactive effect, and the worst cases exhibited more than one symptom.

So where does this leave us? Well, in the new financial system, regardless of who pays for the thrifts and how much it costs, there are simply going to be fewer institutions dedicated by charter to finance real estate. What institutions survive may specialize in traditional thrift areas but this will be by *choice* rather than *mandate*. But that doesn't mean a return to the bad old days when the mortgage market was isolated and treated by policy makers as a can of silly putty. Rather the place of the thrifts has been, and will be, taken by a spectrum of investors, originators and services ranging from Fannie Mae and Freddie Mac down to individual investors purchasing mortgage securities through their brokers.

REALTORS® need to recognize these changes and understand they need to traverse a whole new financial landscape. Funds will be available at the market, but often through sources previously unrecognized. Just as financing is the key to sales, seeing this overturned world is the key to finance. After all, we'd much rather be Washington than Cornwallis.

Outlook for the Economy and Real Estate

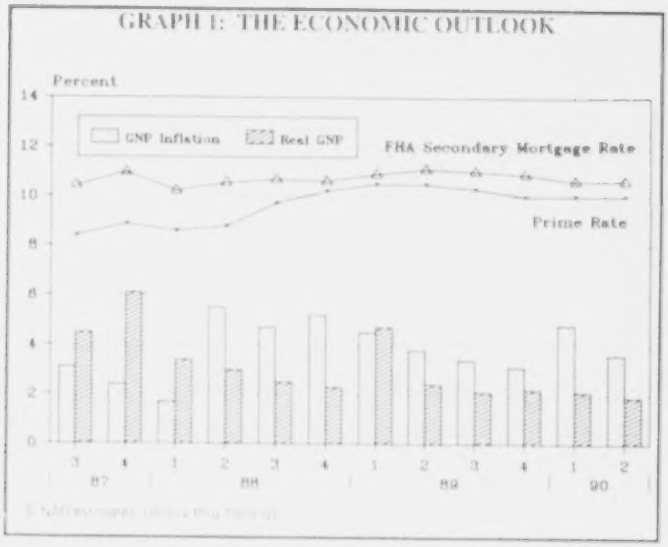
THE ECONOMIC OUTLOOK

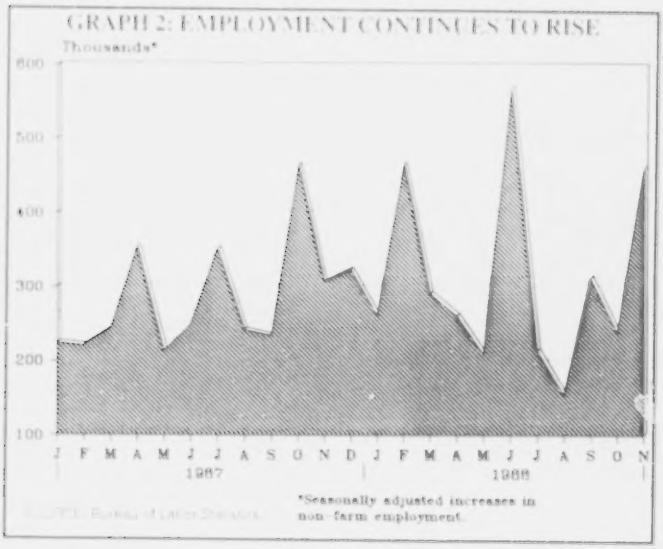
With all the changes that a new year typically brings, economic growth appears to be one of the few constants, as the economy appears poised to continue its record peacetime expansion through 1989. The U.S. Department of Commerce made relatively few changes in December to its estimate for third quarter real GNP growth; the final estimate is now at 2.5 percent, virtually unchanged from the prior estimate of 2.6 percent. In 1988, the severe drought pulled down these real GNP estimates because of the lower levels of farm production, but in doing so they obscured the continued strong growth of the non-farm economy in 1988. Concern by the monetary authority about the fast pace of non-farm economic growth is largely responsible for the recent rise in short-term interest rates and the flattening of the yield curve. Specifically, the non-farm sector of the economy alone grew at a robust annual rate of 4 percent in the first half of 1988, and at a 3.3 percent annual rate in the third quarter. Clearly, while the pace of economic growth may be slowing down, the economy still maintains a hearty head of steam heading into 1989. In the fourth quarter, economic growth appeared to be moving forward with a great deal of momentum, as indicated by reports of increased retail sales (up 1.1 percent in November), expanding industrial production (up 0.5 percent in November) and strong employment gains.

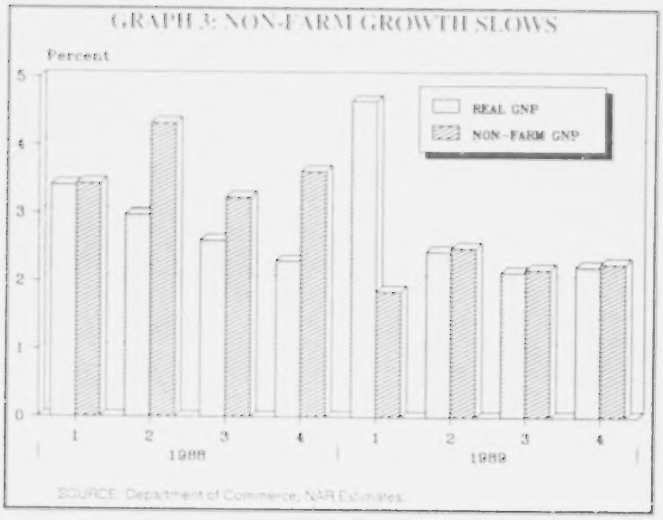
Job Growth Continues

The November employment report showed a surprisingly large advance in employment of 465 thousand new jobs. This employment report adds to the list of indicators that the economy may be growing too quickly, and that inflationary pressures could be mounting. The report undoubtedly raised eyebrows at the Federal Reserve, where the economy is viewed as being at or near a full-employment level. Continued employment growth during times of low unemployment can lead to price increases as employers are forced to offer higher wages in their bid for a limited supply of available workers. At the same time, labor unions can become increasingly confident about making higher wage demands. As we reported last month, employment growth in excess of 300,000 new jobs could lead the Fed to draw credit in even tighter by pushing up short term interest rates; and there is strong evidence that this is exactly what has happened (more on this later). By tightening credit the Fed expects to slow economic growth (including employment growth) in the hopes of keeping the rate of inflation under control.

As Graph 3 shows, the non-farm economy has been growing much more strongly than the recent real GNP growth estimates suggest. However, the rate of non-farm growth is slowing down and approaching the long-term trend rate of growth of 2.5 percent though.. to be desired by the Fed. In 1989, economic growth should continue on this path toward a "gentle landing" from the rapid advance of recent years. However, real GNP growth in the first quarter of 1989 will likely reach 4.7 percent as farm production stages a comeback from the depressed levels of the drought. Again, farm production will likely cloud the underlying growth trend o. non-farm economy, but only during the first part of 1989.







Monetary Policy and Interest Rates

The Federal Reserve continues to feel the pressure for tighter credit as higher foreign interest rates, a softer dollar, and strong U.S. economic growth keep the heat on. Exchange markets reacted to the $10.3 billion trade deficit in October by pushing the dollar lower, fearing that the deficit improvements made during the beginning of 1988 have stalled. In addition, by the middle of December, all of the major European countries, concerned by the growth rate of their own economies, had followed the Bank of England's lead taken in late November, and raised their official interest rates. Given the anti-inflationary stance of the Fed, the Fed is expected to raise the discount rate from 6.5 percent to 7.0 percent in the very near future in order to keep the dollar from falling any further. In fact, banks have already reacted to these pressures on interest rates by raising their prime lending rate from 10.0 percent in November to 10.5 percent by mid-December.

With or without a discount rate hike, the Fed's tightening over the past two months has been evident in the rise of short-term interest rates. The three month Treasury bill has risen from its November average of 7.68 percent to 8.1 percent while the 1-year bill is yielding over 9 percent and is now slightly higher than the 30-year Treasury bond. The result has been a near inversion at the tail end of the yield curve. The yield curve is expected to steepen in the next few months, as the inflation expectations embodied in the short-term rates find move into the long-term rate structure. Mortgage rates have been moving steadily upwards in the past month with the commitment rate on a fixed rated mortgage jumping almost 50 basis points from its November average to 10.75 in December. This rise is expected to continue, peaking by the spring of next year at 11.1 percent.

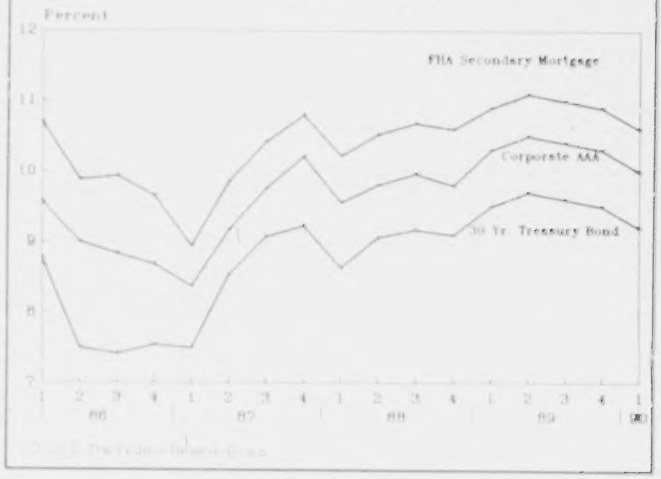
REAL ESTATE MARKETS

Housing Starts

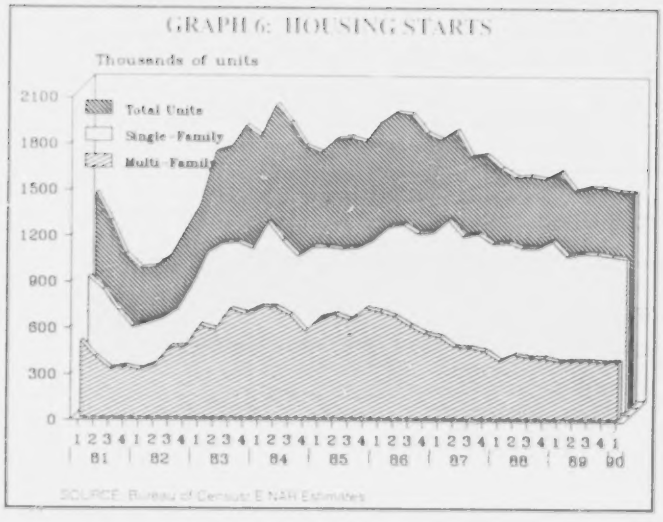
Starts of privately owned homes reached a seven month high in November at a seasonally adjusted annual rate of 1.563 million units, up 1.4 percent from the October revised pace of 1.542 million units. The increased activity in housing starts came as a pleasant surprise, given that starts were expected to slow as homebuyers reacted to the return of higher mortgage rates . It seems that potential homebuyers took the November rise in interest rates into account in their buying decisions; thus prompting many to act ahead of further rate rises. The rise in mortgage rates during December is expected to continue through the spring of 1989, slowing housing activity and lowering starts from 1.48 million units in 1988 to 1.397 in 1989. Starts of single-family homes were up 0.8 percent from October (2.0 percent from a year ago) to a seasonally adjusted annual rate of 1.151 million units, the fastest pace since March of 1988. As for multi-family homes, those with 2-4 units were started at an annual rate of 64 thousand units in November (3.2 percent faster than the October rate and 25.5 percent faster than November 1987), while those with 5 or more units were up 3.0 percent in November to a seasonally adjusted annual rate of 348 thousand units (27.7 percent below November 1987).

GRAPH 4: THE INVERSION OF THE YEILD CURVE

GRAPH 5: FORECAST FOR LONG-TERM INTEREST RATES



GRAPH 6: HOUSING STARTS



SOURCE: Bureau of Census & NAR Estimates

New Home Sales

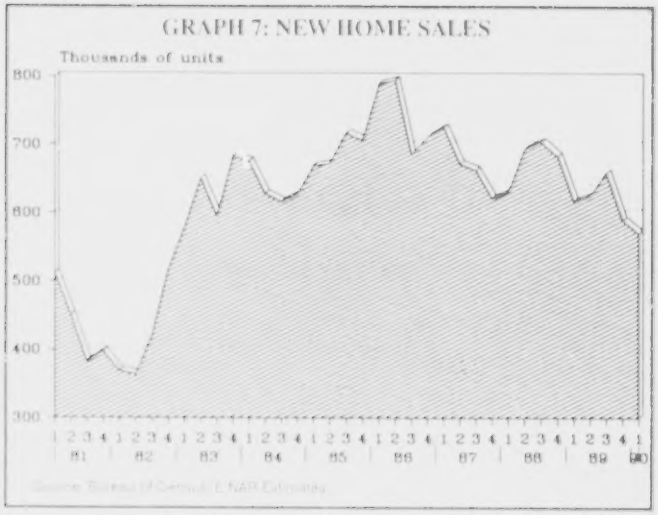
Following a revised 1.4 percent drop in September (previously estimated at negative 7.8), new single-family home sales rose by 3.5 percent in October to a seasonally adjusted annual rate of 733 thousand units, marking the fastest pace since February 1987. As discussed last month, housing activity picked up in October following a drop in interest rates, prompting many who correctly anticipated a return to higher rates to move up their home purchases. Regionally, the Northeast reported the greatest sales increase, with new home sales advancing 14.6 percent to a seasonally adjusted annual rate of 110 thousand units. Sales in the Midwest rose 8.1 percent to an annual rate of 107 thousand units, which was 9.1 faster than the October 1987 annual rate of 98 thousand units. The South was the only region to experience a sales decline, falling 3.9 percent to a seasonally adjusted annual rate of 249 thousand units, but up 1.6 percent from a year ago. In the West, new home sales continued their climb, rising 5.1 percent in October to a seasonally adjusted annual rate of 266 thousand units, which is a 36.4 percent gain over the October 1987 rate of 195 thousand units.

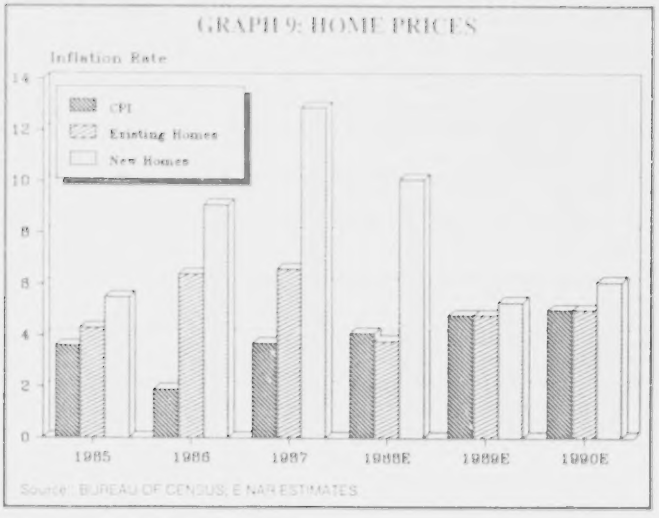
Existing Home Sales

Sales of existing single-family homes rose to a seasonally adjusted annual rate of 3.71 million units in November, 1.1 percent above the October 1988 annual rate of 3.67 million units. Existing single-family home sales rose 10.1 percent above their November 1987 annual rate of 3.37 million units. Contrary to most expectations in the late summer, home sales have been surprisingly strong throughout the fall. Much of this unexpected strength was due to the brief dip in mortgage rates, however, it appears that homebuyers are now trying to keep one step ahead of the even higher interest rates expected in the early part of next year. A slowdown in sales in the very near future is possible if mortgage rates continue to climb above the 11.0 percent mark, and if 1-yr. ARM rates rise with other short-term interest rates. In response to the rising rates, existing home sales could soften to an annual rate of 3.405 million units in the first quarter of 1989, down 7 percent from the 3.63 million unit sales pace of the last quarter of 1988.

Home Prices

The median sales price of an existing single family home fell slightly in November to $87,900, 0.2 percent below the October median sales price of $88,100, and 3.4 percent above the November 1987 median price of $85,000. Existing single-family home prices have been slipping since August, when the median price peaked at $91,400. In addition, the average price of an existing single-family home has also been on the decline, falling 4.1 percent from its August high of $115,100 to $110,400 in November. As for new homes, the median price fell 1.0 percent in October to $115,900, an 8.8 percent increase over the October 1987 median sales price of $106,500. The average price of a new single-family home was $140,100 in October, down 2.0 percent from August but up 11.4 percent from the October 1987 average price of $125,000.





REGIONAL DATA

Housing Starts

The November rise in the national rate of housing starts was brought about by increases in both the South and Northeast. In the Northeast, after being the only region to report a slowdown in October, housing starts sped up by 12.9 percent to a seasonally adjusted annual rate of 228 thousand units. Housing starts rose by 4.8 percent in the South to an annual rate of 612 thousand units, marking the fastest rate since November of last year when homes were started at a rate of 648 thousand units. Following a 14.8 percent increase in October, starts fell 2.2 percent in the West to a seasonally adjusted annual rate of 479 thousand units, 11.1 percent faster than a year ago. In the Midwest, housing starts slowed by 8.3 percent to an annual rate of 244 thousand units, putting starts in the Midwest 22 percent below the rate of November 1987.

Existing Home Sales

November proved to be a good month for housing activity in the Northeast, as sales of existing single-family homes ended their four month decline and jumped 4.6 percent to a seasonally adjusted annual rate of 680 thousand units; putting sales in the Northeast 6.3 percent above the November 1987 annual rate of 640 thousand units. Strong sales were also found in the Midwest, where existing homes were sold at an annual rate of 960 thousand units, 4.3 percent above the October annual rate of 920 thousand units and 7.9 percent above the sales rate of one year ago. In the South, sales were unchanged at 1.4 million units, marking an 11.1 percent increase over November 1987 sales, when homes were sold at an annual rate of 1.26 million units. In the West, for the first time in 1988, sales of existing single-family homes fell for two consecutive months, dropping by 7.0 percent in November to a seasonally adjusted annual rate of 660 thousand units. However sales were considerably stronger than a year ago (up 17.9 percent) when existing homes were sold at an annual rate of 560 thousand units.

Home Prices

The moderate drop in the median sales price of an existing single-family home was shared by all four regions. In the South, the median sales price dipped slightly from the October revised price of $80,500 to $80,300 in November. Prices have been rather flat in the South during the past year, and the November median price was only 1.4 percent higher than the November 1987 median price of $79,200. In the West, the median price dropped 0.4 percent to $122,300, 6.0 percent higher than the median price of one year ago. The median price in the Midwest was $66,700 in November, down 1.0 percent from October but up 3.6 percent from a year ago. In the Northeast, following a 5.0 percent upward revision of the October median sales price to $144,400, the median price dropped 1.3 percent to $142,500, 5.9 percent above the November 1987 price.

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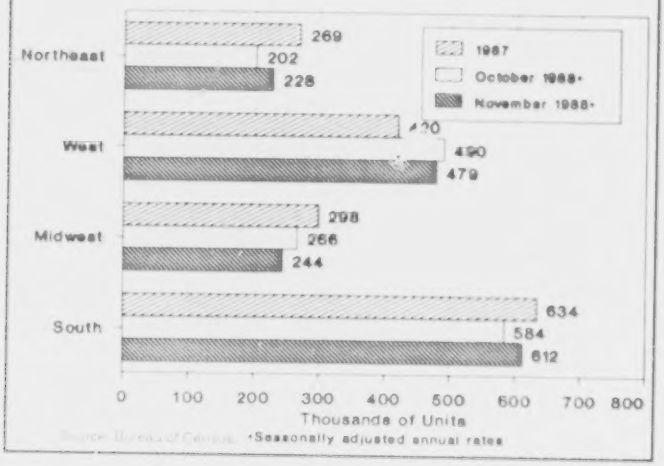
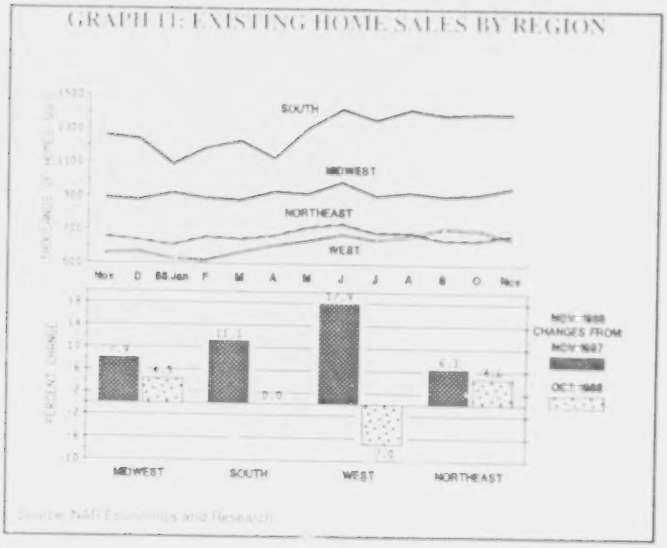
GRAPH 10: HOUSING STARTS BY REGION



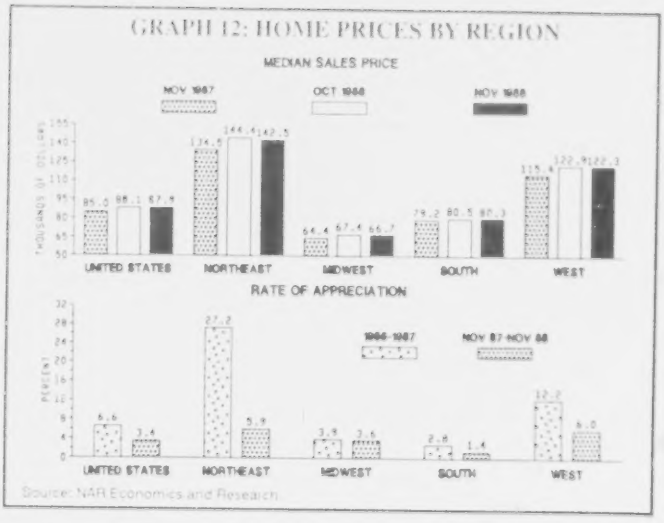
Source: Bureau of Census

GRAPH 11: EXISTING HOME SALES BY REGION



Source: NAR Economics and Research

GRAPH 12: HOME PRICES BY REGION



Source: NAR Economics and Research

U.S. ECONOMIC OUTLOOK

JANUARY 1989

	QUARTERS								YEARS				
	ACTUAL			FORECAST					ACTUAL		FORECAST		
	88.2	88.3	88.4	89.1	89.2	89.3	89.4	90.1	1986	1987	1988	1989	1990
AGGREGATE ECONOMY													
Gross National Product													
(billions of dollars)	4824	4909	5001	5113	5192	5263	5333	5424	4240	4527	4865	5226	5543
% Change	8.7	7.3	7.7	9.3	6.3	5.6	5.4	7.0	5.6	6.8	7.5	7.4	6.1
% Change (w/out inflation)	3.0	2.5	2.3	4.7	2.4	2.1	2.2	2.1	2.8	3.4	3.9	3.0	2.1
Consumer Price Inflation (CPI)	4.8	4.7	4.6	4.8	4.8	4.8	4.8	5.9	1.9	3.7	4.1	4.8	5.0
GNP Inflation (GNP Deflator)	5.5	4.7	5.2	4.5	3.8	3.4	3.1	4.8	2.7	3.3	3.4	4.3	3.9
Unemployment Rate - Civilian	5.4	5.5	5.3	5.4	5.4	5.4	5.3	5.4	7.0	6.2	5.5	5.4	5.5
Civilian Employment-Household Basis (millions)	114.6	115.2	115.9	116.3	116.8	117.3	117.7	118.2	109.6	112.4	115	117	118.7
Percent change	1.5	1.9	2.5	1.3	1.8	1.7	1.6	1.4	2.3	2.6	2.3	1.8	1.4
Index of Industrial Production	136.0	138.4	139.9	141.1	141.8	142.5	143.3	144.7	125.1	129.8	137.2	142.2	144.7
Manufacturing Capacity Utilization	83.2	84	84.4	84.5	84.7	84.6	84.5	84.4	79.7	81	83.5	84.6	84.3
Domestic Auto Sales	7.5	7.5	7.0	7.3	7.0	7.1	7.1	7.0	8.2	7.1	7.4	7.1	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.4	19.9	20.1	20.2	20.3	20.3	20.4	21.0	19.5	20.2	20.1	20.3	21.0
Federal Expenditures (NIPA) as % of GNP	23.1	22.4	22.9	22.8	22.8	22.8	22.8	23.0	24.4	23.7	23.0	22.8	23.0
Deficit (NIPA)	-133.3	-104.8	-143.3	-132.5	-128.2	-124.5	-112.3	-108.5	-205.5	-157.8	-139.1	-130.6	-111.1
as % of GNP	-2.8	-2.5	-2.9	-2.6	-2.5	-2.4	-2.2	-2.0	-4.9	-3.5	-2.9	-2.5	-2.0
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales													
(thousands, single-family resales plus													
97 percent of single-family starts)	4674	4701	4647	4397	4448	4523	4439	4246	4712	4648	4584	4401	4279
Percent change -- year ago	0.5	1.8	4.6	2.0	-4.8	-3.8	-4.6	-3.2	10.8	-1.4	-1.4	-4.0	-2.8
Existing Single-family Home Sales (thousands)	3643	3670	3630	3495	3460	3521	3459	3376	3565	3526	3539	3413	3307
Percent change -- year ago	0.9	7.0	5.3	4.8	-5.3	-3.9	-4.5	-3.8	10.9	-1.1	0.2	-3.4	-3.1
Housing Starts (thousands)	1481	1466	1508	1368	1410	1434	1384	1376	1612	1634	1482	1397	1383
Percent change -- year ago	-7.8	-9.7	-1.6	-6.0	-4.8	-2.7	-8.2	0.0	4.1	1.4	-9.3	-5.7	-1.0
Single-Family Units	1063	1063	1110	1013	1029	1027	1010	999	1183	1157	1083	1020	1009
Percent change -- year ago	-6.5	-7.9	1.9	-7.7	-3.2	-3.4	-9.0	-1.4	10.4	-2.2	-6.4	-5.9	-1.7
Multi-Family Units	419	420	398	376	381	407	374	378	530	477	399	378	381
2-4 Family Units	57.3	56	53.0	55.8	56.6	56.5	55.5	56.1	64.5	65.7	58.0	56.1	56.6
Percent change -- year ago	20.4	7.2	4.8	-1.0	-1.2	4.7	4.8	0.5	9.0	22.6	-11.8	-3.3	0.8
5+ Family Units	360	347	339	320	325	344	318	322	545	412	341	322	324
Percent change -- year ago	9.1	-16.9	-12.5	-1.2	-9.9	-4.8	-6.0	0.5	5.6	-24.4	-17.2	-5.6	0.6
New Single-family Home Sales (thousands)	697	705	683	617	626	660	630	670	750	671	679	623	585
Percent change -- year ago	3.4	4.4	10.0	-2.1	10.3	6.4	-13.6	7.6	9.0	-10.5	1.2	-8.2	-6.1
Mobile Homes Shipped (thousands)	220	216	227	219	220	226	230	228	246	233	219	225	232
HOME PRICES													
Existing Home Prices - Median $(1000)	88.9	90.2	88.8	90.4	92.7	94.1	94.6	95.1	80.3	85.6	88.9	93.1	97.8
Percent change -- year ago	4.6	5.5	4.1	3.0	4.3	5.0	6.5	5.2	6.4	6.6	3.8	4.8	5.0
New Home Prices - Median $(1000)	112.9	115.5	116.5	117.0	119.8	122.6	122.9	123.8	92.0	104.0	114.5	120.6	127.9
Percent change -- year ago	9.1	8.9	4.2	3.6	6.1	6.1	5.5	5.8	9.1	12.9	10.1	5.3	6.1
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year FRM (FHA Secondary)	10.6	10.8	10.8	10.9	11.1	11.2	10.9	10.8	9.9	10.2	10.5	11.0	10.5
1-year ARM (w/mout buydown)	7.6	7.6	7.6	8.1	8.2	8.2	8.1	8.0	7.9	8.2	7.5	8.2	7.6
Corporate AAA Bond Rate	9.8	10.0	9.8	10.3	10.5	10.4	10.3	10.0	9.0	9.4	9.3	10.4	9.9
Government Bond Rate	9.1	9.2	9.1	9.5	9.7	9.6	9.5	9.2	7.8	8.6	9.0	9.6	9.1
Short-Term Interest Rates													
Federal Funds Rate	7.2	8.0	8.4	8.6	8.7	8.6	8.4	8.3	6.8	6.7	7.6	8.6	8.2
3-month T-Bill Rate	6.2	7.0	7.7	7.9	8.0	7.9	7.5	7.4	6.0	5.8	6.7	7.8	7.2
Prime Rate	8.8	9.7	10.2	10.5	10.6	10.3	10.0	10.0	8.3	8.2	9.3	10.3	9.7
Discount Rate	6.0	6.3	6.5	7.0	7.0	6.9	6.5	6.5	5.3	5.7	6.2	6.5	6.7
Value of the U.S. Dollar (Trade-Weighted Avg.)	90.4	97.6	92.3	89.6	88.5	85.5	82.6	81.2	112.3	96.9	92.5	86.6	81.0
Percent change	1.7	35.6	-20.0	-11.0	-4.9	-12.8	-13.1	-6.5	-21.6	-13.6	-4.5	-6.5	-6.4

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr Frederick Flick, Sean Burns and Beth Maerz

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